contrary, such mandatory unbundling will reduce CLEC investment.

4. In Part III, we explain how mandatory unbundling at TELRIC prices is not necessary to protect consumers in related telecommunications markets. In Part IV, we demonstrate that the Hubbard-Lehr-Willig impairment standard is ill-conceived and unworkable. Part V shows that the national unbundling prescription of Professors Hubbard, Lehr, and Willig cannot be reconciled with consumer welfare and the accepted economic techniques of competitive analysis. Professors Hubbard, Lehr, and Willig ignore the costs to consumer welfare that would result if the Commission were to accept their advice of needlessly imposing nationwide unbundling outcomes that ignore the competitive differences that exist across relevant geographic markets.

I. Professors Hubbard, Lehr, and Willig Flout the Supreme Court's Decision in *Iowa Utilities Board* by Subordinating Consumer Welfare to Competitor Welfare

5. Professors Hubbard, Lehr, and Willig say that the goal of the Telecommunications Act is to "maximize competitive entry and promote maximum feasible competition."[5] That assessment is false. It produces an incorrect standard because it ignores that the legislation's purpose is to maximize *consumer welfare*. Indeed, under the Hubbard-Lehr-Willig approach, the FCC could increase competitive entry and increase this strange version of "competition" by *subsidizing* entrants, through a tax on either ILECs or consumers. Either tax would lead to consumer harm yet would stimulate CLEC entry. Most CLECs, however, would

enter even *without* the FCC subsidy. For example, the CLEC could invest in a network technology with a lower marginal cost than the ILEC's legacy network, differentiate its services (by bundling, for example, local service with long-distance or cable television), or target only low-cost customers (which the ILECs cannot do because it must serve as the carrier of last resort). Thus, Professors Hubbard, Lehr, and Willig cannot claim that, because a *given* CLEC might decide not to enter, there would be any adverse effect on competition or consumer welfare.

6. A consumer-welfare standard will diverge from a competitor-welfare standard whenever the welfare of particular competitors does not reflect the welfare of consumers. As we argued in our original affidavit, there is no necessary relationship between CLEC profits and consumer welfare under an imperfectly competitive outcome.[6] In particular, the two standards will produce different policy prescriptions for mandatory unbundling whenever competition exists at the end-user service level but not at the input level.[7]

7. Professors Hubbard, Lehr, and Willig look to the effect on the *requesting CLEC* rather than the effect on competition.[8] In so doing, they fail to follow even their own so-called "competition-based" approach.[9] A given CLEC might be disadvantaged, but from that fact one cannot infer any effect on consumer welfare or on competition. For instance, another CLEC

5. *Id.* at 6 ¶ 15.
6. *Hausman-Sidak Affidavit* at 51 ¶ 66.
7. For a detailed description of how consumer-welfare and competitor-welfare impairment standards relate, see *id.* at 115 ¶¶ 157-60.
8. *Hubbard-Lehr-Willig Affidavit* at 6 ¶ 16.
9. *Id.* at 4 ¶ 11.

might be offering a perfect substitute over its own facilities for the service of the requesting CLEC. If the other CLEC knows that the requesting CLEC can free ride or otherwise be given a subsidy by regulation, it will invest less in its own facilities, with all the resulting problems that we discussed in our earlier affidavit.

8. With no support from legislative history, Professors Hubbard, Lehr, and Willig suggest that the Telecommunications Act of 1996 imposes, in section 251(d)(2), standards for mandatory unbundling that "go far beyond those imposed by antitrust standards and other prohibitions of acts of monopolization."[10] Although Professors Hubbard, Lehr, and Willig discuss the implications of the Supreme Court's ruling *before* defining their impairment standard, no trace of the Court's reasoning or holding can be found *within* the statement itself: "The question, therefore, is what regulatory standards will best advance the objectives of assuring that consumers of exchange and exchange access services receive the maximum benefits of competition in both the short and the long term. We conclude that the standard that will best advance these interests is a competitive benchmark."[11] On that basis, Professors Hubbard, Lehr, and Willig disregard the Supreme Court's guidance on how the Commission should develop the appropriate "impairment" standard.

9. At the end of their affidavit, Professors Hubbard, Lehr, and Willig summarize their argument by asserting that "*any* increase in cost or delay, or a decrease in quality

10. *Id.* at 6 ¶ 15. This assessment is inconsistent with Justice Breyer's belief in the relevance of the essential facilities doctrine to interpretation of section 251(d)(2). *Iowa Utilities Board*, 119 S. Ct. at 753 (Breyer, J., concurring on "necessary" and "impair").

resulting from an incumbent LEC's failure to unbundle a network element will impair a CLEC's ability to offer service."[12] That statement is breathtaking. It encapsulates, virtually verbatim, what the Supreme Court emphatically rejected in *Iowa Utilities Board.* Justice Scalia wrote for seven members of the Court that "the Commission's assumption that *any* increase in cost (or decrease in quality) imposed by denial of a network element renders access to that element 'necessary,' and causes the failure to provide that element to 'impair' the entrant's ability to furnish its desired services is simply not in accord with the ordinary and fair meaning of those terms."[13] Professors Hubbard, Lehr, and Willig, in other words, *do not propose any limiting principle at all* for the Commission's interpretation of "necessary" and "impair." Rather, they invite the Commission to flout the *Iowa Utilities Board* decision by adopting the identical standard for mandatory unbundling that the Court found to be contrary to law. We can only surmise that Professors Hubbard, Lehr, and Willig did not appreciate the legal significance of the remand ordered by the Supreme Court in *Iowa Utilities Board.*

II. CONTRARY TO THE CLAIMS OF PROFESSORS HUBBARD, LEHR, AND WILLIG, MANDATORY UNBUNDLING AT TELRIC PRICES WILL NOT STIMULATE CLEC INVESTMENT IN NETWORK FACILITIES

10. Professors Hubbard, Lehr, and Willig view mandatory unbundling at TELRIC prices as a short-term fix to what they perceive to be the CLEC investment problem. In their view, unbundling will provide a CLEC a "taste" of demand conditions in the relevant market

11. *Hubbard-Lehr-Willig Affidavit* at 6 ¶ 16.

for which it is considering entry as a facilities-based competitor: "CLECs can mitigate many of these cost and strategic disadvantages by replacing UNEs with their own facilities once they have developed a significant customer base and learned about customer demand and traffic flows. In this respect, UNEs act as a bridge to facilities-based competition."[14] Once a CLEC acquires this knowledge, the argument goes, the risk of its investment decision will diminish and hence investment will appear more attractive to the CLEC.

11. The reasoning supporting this argument crumbles on inspection. First, the Professors Hubbard, Lehr, and Willig admit that a CLEC regards self-provision as more advantageous than leasing unbundled elements from the ILEC's network. If so, then why should a CLEC *wait* to "mitigate this cost disadvantage" by delaying its conversion to a full-fledged, independent, facilities-based competitor?[15] Why would the CLEC not desire to climb this learning curve as quickly as possible? Second, there are ways besides mandatory unbundling for a CLEC to learn about the demand conditions of a particular geographic market. For example, a reseller of minutes could learn about demand just as easily as a CLEC that has chosen to lease an ILEC's elements. Third, the bewildered CLECs of which Professors Hubbard, Lehr, and Willig speak include AT&T, MCI-WorldCom, and Sprint. AT&T owns Teleport, MCI-WorldCom owns MFS, and Sprint provides (as the ILEC) millions of

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12. *Id.* at 21 ¶ 42 (emphasis added).
13. *Iowa Utilities Board,* 119 S. Ct. at 735 (emphasis in original).
14. *Hubbard-Lehr-Willig Affidavit* at 17 ¶ 34.
15. *Id.* at 13 ¶ 27.

local exchange access lines.[16] Professors Hubbard, Lehr, and Willig cannot seriously portray these three prominent CLECs as ignorant and unsophisticated about the nature of demand for local telecommunications services. Many small CLECs have employed switches without this hypothetical inside information.

12. As we discussed in the first round of filings for this proceeding, an overly generous unbundling policy will undermine, not stimulate, CLEC investment in network facilities.[17] First, mandatory unbundling at TELRIC prices encourages CLECs to delay facilities-based entry into the local services market. Mandatory unbundling at TELRIC is equivalent to the government's grant to the CLEC of a *free option* to consume, at incremental cost, the fruits of the ILEC's investment. Facilities-based entry involves sunk costs, which necessarily imply greater risk than UNE-based entry. Thus, a given CLEC will not invest as much in facilities if other CLECs receive free options to unbundle the ILEC's elements at cost because it will not reap the full rewards of its investment. Professors Hubbard, Lehr, and Willig fail to account for the sunk-cost nature of facilities-based investment, even though they earlier state that much network investment is "fixed or sunk."[18]

13. Second, a generous unbundling policy encourages CLECs to demand a "bug free" version of the ILEC's network element and to request, at no cost to the CLEC, the

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16. As of March 1999, Sprint served 7.6 million access lines in 18 states. *See* SPRINT CORP., 1999 SEC FORM 10-K, at 2 (1999)

17. For a detailed review of those effects, see Affidavit of Thomas M. Jorde, J. Gregory Sidak & David J. Teece on behalf of the United States Telephone Association 35-42 (May 26, 1999); *Hausman-Sidak Affidavit* at 57 ¶ 75.

18. *Hubbard-Lehr-Willig Affidavit* at 9 ¶ 20.

offering of unbundled network elements from the ILEC with no intention of actually using them.

14. Third, mandatory unbundling at TELRIC prices diminishes a CLEC's incentive to provide "plain old telephone service" (POTS) by innovative means. For example, an ill-conceived unbundling policy can undermine a CLEC's efforts to deploy POTS over a digital subscriber line (DSL) without the use of any circuit-switching apparatus.

III. Contrary to the Claims of Professors Hubbard, Lehr, and Willig, Mandatory Unbundling at TELRIC Prices Is Not Necessary to Protect Consumers in Related Telecommunications Markets

15. Professors Hubbard, Lehr, and Willig suggest that unbundling is necessary to promote competition (and, presumably, consumer welfare) in related telecommunications markets. For example, they say that unbundling "will be critical to protecting competition in the long distance market and broader emerging market for 'all distance' one-stop shopping services."[19] Do Professors Hubbard, Lehr, and Willig really believe that an ILEC could exercise market power in the *long-distance* market given what they presumably consider to be its current competitive state? Professors Hubbard, Lehr, and Willig then suggest that unbundling "represents the *only* method by which long distance carriers and others can ubiquitously offer their own one-stop shopping alternatives while incurring costs for the local

19. *Id.* at 13 ¶ 27.

components that are even remotely close to those that BOCs incur."[20]

16. Professors Hubbard, Lehr, and Willig overlook that their own client is a long-distance carrier that has invested tens of billions of dollars with the intention of shortly offering one-stop shopping over cable television lines, without any use of the ILEC's unbundled network elements.[21] In addition, several wireless carriers, such as Nextel and Sprint, offer bundled packages that include local service with long-distance service at no extra charge. Certainly, those carriers do not require access to the ILEC's network elements, let alone mandatory access at TELRIC prices.

17. Professors Hubbard, Lehr, and Willig are trapped in a narrow, competitor-welfare framework. That framework blinds them—even as they submit expert testimony on behalf of the firm that bought or is buying McCaw Cellular, Teleport, TCI, and MediaOne and has entered into joint ventures with Time Warner and Microsoft—to any consideration of telecommunications competitors outside the conventional model of ILECs and CLECs.

IV. The Hubbard-Lehr-Willig Competitor-Welfare Standard Is Ill-Conceived and Unworkable

18. In our earlier affidavit, we described generically a competitor-welfare standard for mandatory unbundling, not knowing what AT&T's economic experts would actually advocate. It turns out that Professors Hubbard, Lehr, and Willig advocate a much more

20. *Id.* (emphasis added).

21. For a review of AT&T's plans to offer cable telephony, see Peter Elstrom, Richard Siklos, Roger Crockett, Catherine Yang, & Amy Barrett, *AT&T: What Victory Means*, BUS. WK., May 17, 1999, at 34.

invasive standard for mandatory unbundling than we had envisioned. We would expect their standard to compel unbundling in an even larger set of competitive circumstances than we described in our earlier affidavit.

A. Professors Hubbard, Lehr, and Willig Fail to Articulate a Coherent Competitor-Welfare Standard

19. A competitor-welfare standard is inappropriate for interpreting section 251(d)(2). But even if one were to take seriously a competitor-welfare standard, Professors Hubbard, Lehr, and Willig have failed, for at least three reasons, to present such a standard in a well-defined and operationally feasible manner.

20. First, a CLEC's ability to compete is, at a minimum, two-dimensional: It makes no sense to ask whether denying a CLEC access to a UNE at a TELRIC price would raise the CLEC's cost *in and of itself* or lower the CLEC's quality of service *in and of itself.* This is analogous to indifference curves in consumer theory, which reflect the tradeoff in utility between consuming different combinations of two goods.[22] Simply because a consumer has less of one good (or less of some aspect of a good) does not necessarily mean that the consumer is worse off.[23] A meaningful question would be whether the consumer is worse off given that she has *more* of the other good. In producer theory, the analogous construct is the production-

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22. *See, e.g.*, WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY 119-21 (Dryden Press 7th ed. 1997).

23. Consumers derive utility from many different features of a good, and thus the deprivation of *one* feature does not imply that the consumer is worse off. *See, e.g.* DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 18 (Princeton University Press 1990).

possibility frontier, which also is a function of two or more inputs.[24]

21. To relate this insight back to the matter at hand, it is not meaningful to ask whether the CLEC is worse off simply because it has less of a particular input—namely, the *ILEC's* network element. If, while pursuing an alternative business plan, the CLEC can offer a higher quality of service, then by no means will it be worse off. Alternatively, if a decrease in service quality is offset by a decrease in cost, then the CLEC may not be worse off. For example, an alternative CLEC business plan may involve substitution between switching and transport.[25] Thus, the question of whether a CLEC that was denied access to the ILEC's network element at a TELRIC price would "experience greater delays in offering service, reduce the scope of its services, *or* offer lower quality services"[26] is, as currently posed by Professors Hubbard, Lehr, and Willig, nonsensical.

22. Second, a CLEC must be impaired *relative to a predetermined set of options*. Again, without specifying what options are available to the CLEC and hence what it could achieve in the absence of mandatory unbundling, it is meaningless to ask whether a CLEC's inability to lease a particular network element at a TELRIC price would impair the CLEC's ability to compete. For example, if a CLEC could achieve the same level of profits by self-

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24. *See, e.g.*, HAL R. VARIAN, MICROECONOMIC ANALYSIS 2 (W.W. Norton & Co. 3rd ed. 1992).

25. For a description of the tradeoffs between switching and transport, see Jerry A. Hausman, *Proliferation of Networks in Telecommunications*, in NETWORKS, INFRASTRUCTURE, AND THE NEW TASK FOR REGULATION (D. Alexander & W. Sichel, eds., University of Michigan Press 1996). One of us has made the analogous argument about the production-possibility tradeoffs that exist between spectrum and equipment (including cell sites and transmitters) in wireless telecommunications. *See* J. Gregory Sidak, David J. Teece & Hal J. Singer, *A General Framework for Competitive Analysis in Wireless Telecommunications*, 51 HASTINGS L.J. (forthcoming 1999).

26. *Hubbard-Lehr-Willig Affidavit* at 7 ¶ 16 (emphasis added).

provisioning the network element or provisioning it through a third party, then certainly the CLEC would not be impaired for purposes of section 251(d)(2). By failing to recognize that important aspect of competitive impairment, Professors Hubbard, Lehr, and Willig fail to heed the Supreme Court's instruction to examine the competitive significance of facilities that are supplied outside the ILEC's network.

23. Third, any competitor-welfare impairment standard should ask *to what extent* the CLEC is harmed. According to Professors Hubbard, Lehr, and Willig, however, even the slightest reduction in the quality or scope of services offered represents impairment and hence triggers the Commission's mandatory unbundling of the ILEC's network elements at TELRIC prices. That extreme position fails the Court's requirement in *Iowa Utilities Board* that an impairment standard consider the degree of competitive harm.[27] By the logic of Professors Hubbard, Lehr, and Willig, a demonstration of CLEC harm in the amount of one dollar could trigger mandatory unbundling at TELRIC prices. As shown by Justice Scalia's ladder-and-light-bulb dialogue with Justice Souter in *Iowa Utilities Board,* seven members of the Supreme Court expressly rejected such reasoning.[28]

B. The Competitive Entry Assumptions of Professors Hubbard, Lehr, and Willig Are Incorrect in Theory and Practice

24. According to the Hubbard-Lehr-Willig "razor's edge" view of CLEC entry, there is no continuum between equal profitability with ILECs and zero profits. A CLEC will

27. 119 S. Ct. at 735.

"enter a particular local services market only if it anticipates that its costs will not exceed those of the incumbent LEC for a similarly desirable product."[29] They base that conclusion on an oversimplified competitive environment in which the CLEC competes with an ILEC á la Bertrand (that is, only on the basis of price) with complete information along a single product dimension. The statement that we quote above by Professors Hubbard, Lehr, and Willig invites the question, What if the CLEC offers a *differently* desirable product? As we noted in our earlier affidavit, CLECs differ in their competitive strategies, their service offerings, the value of their brand names and reputation, and so forth. Given that AT&T has acquired one of the two largest competitive access providers, is acquiring cable television operators, and is expanding its digital one-rate plan for wireless access, it is remarkably *backward-looking* for AT&T's expert economists to ignore product differentiation and instead analyze entry into local telephony under the unrealistic assumption that CLECs and ILECs offer only homogeneous products across identical delivery platforms.

25. Under the Hubbard-Lehr-Willig presumption of no middle ground for CLEC profitability, the Supreme Court (or anyone trying to follow its opinion in *Iowa Utilities Board*) should not be concerned with the *degree* of harm incurred by CLECs—for any cost differential will cause total CLEC annihilation by driving CLEC profits to zero. Moreover, if a CLEC truly has higher costs than the ILEC, then the CLEC should not enter the market.

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28. *Id.* at 735 n.11 (Scalia, J., for the Court) (quoting *id.* at 739 (Souter, J., concurring in part and dissenting in part)).

29. *Hubbard-Lehr-Willig Affidavit* at 8 ¶ 18.

Inefficient entry leads to social waste, which reduces consumer welfare.

26. This simplistic view that Professors Hubbard, Lehr, and Willig have of the CLEC's entry decision is incorrect in both theory and practice. A CLEC will enter a market to provide local service if its expected economic profit (after taking account of its cost of capital) associated with providing service in that market is positive. Whether or not that decision criterion dictates CLEC entry depends on the competitive circumstances of the particular product and geographic market. Even if the CLEC's expected profits associated with providing local service in a given geographic market were negative, it still may enter if its expected profits associated with providing local service *and a complementary service,* such as Internet access, were positive. In short, the CLEC's entry decision is much more complicated than the simple assessment of cost differentials upon which Professors Hubbard, Lehr, and Willig would have the Commission rely.

27. Moreover, not every act of CLEC entry is "marginal entry." Given the "high risks"[30] described by Professors Hubbard, Lehr, and Willig, the CLEC would not enter unless it expected high profits. So slightly higher cost for the CLEC would not affect competition. Thus, most entry is *inframarginal* entry, not the marginal entry that Professors Hubbard, Lehr, and Willig assume. If one marginal entrant declines to enter because of its slightly higher costs, that fact will not impair competition. Using the Hubbard-Lehr-Willig approach, however, the optimal public policy would be to subsidize CLEC entry.

30. *Id.* at 12 ¶ 25.

28. In addition to suffering from this incorrect application of theory, the Hubbard-Lehr-Willig affidavit is contrary to the observed fact of CLEC entry. At an empirical level, Professors Hubbard, Lehr, and Willig make no attempt to explain the entry by CLECs to date. That omission by AT&T's experts is remarkable in light of the fact that AT&T purchased Teleport well after it had already build state-of-the-art networks in many cities. Assuming that cost differentials between ILECs and CLECs exist in practice, the observed fact of CLEC entry directly contradicts the Hubbard-Lehr-Willig entry criterion.

29. Professors Hubbard, Lehr, and Willig also suggest that the "natural competitive process inevitably propels prices below the costs of the high-cost firm."[31] But this is only true in the case of duopoly competition. Consider a case where *three* firms (one cable television operator, one ILEC, and one CLEC) are competing in the provision of local service in a well-defined geographic market.[32] Suppose further that the marginal costs of the cable television operator are lower than the ILEC's marginal costs, which in turn are lower than the CLEC's marginal costs. The cable television operator could price its service just below the ILEC's (the *second* highest-cost firm) marginal costs. In this case, the CLEC would not affect competition; neither would a mandatory unbundling rule that brought the CLEC's costs in line with the ILEC's costs.

30. Professors Hubbard, Lehr, and Willig further assert that CLECs will continue to be impaired until the prices for UNEs "approach *per-unit* TELRIC rates" with competi-

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31. *Id.* at 8 ¶ 18.

tion.[33] The implications of this assertion are not obvious. It is easier to assess this claim in simple notation. Let MC be marginal costs and Q be output. Thus, under Professor Hubbard, Lehr, and Willig's caveat about per-unit TELRIC prices, mandatory unbundling at TELRIC should (as a first approximation) occur until $(MC/Q)_{CLEC} < (MC/Q)_{ILEC}$. That rule would have several serious implications for economic efficiency and consumer welfare.

31. First, assuming that the CLEC and the ILEC have the *same* marginal costs, the Hubbard-Lehr-Willig prescription would call for mandatory unbundling until the CLEC had eclipsed the ILEC's market penetration. Never mind the fact that, by this point, the CLEC would be well past enduring any impairment. Second, this statement about the conditions for competitor impairment directly contradicts the affidavit that Professor Willig submitted with Professor Janusz A. Ordover to the FCC last fall in the AT&T-TCI merger. In particular, Professor Willig argued there that AT&T would not invest in its cable television facilities if the company could receive only TELRIC prices when selling access to other Internet providers:

> Forced unbundling with its attendant regulatory uncertainty would likely slow down the investment in the development of broadband last mile data transport. Investing under the shadow of uncertain regulatory rules in an *innovative* service only exacerbates the already substantial risks associated with that investment. When an investor can be subjected to unanticipated regulatory constraints on its pricing or be required to sell its services at rates that do not reflect proper economic costs, the incentives to invest are potentially undermined. TCI and other cable companies did not sink hundreds of millions of dollars into upgrading their networks on the assumption that they will be forced to "unbundle"

32. Such competition is outside the realm of the Hubbard-Lehr-Willig competitive framework.
33. *Hubbard-Lehr-Willig Affidavit* at 7 ¶ 17 n.4 (emphasis added).

transport *if it is not in their private interest to do so.*[34]

In contrast to the suggestion of Professors Hubbard, Lehr, and Willig in this proceeding that telecommunications firms base pricing decisions on "average costs per subscriber,"[35] economists recognize that firms base such decisions on marginal costs. Thus, the Hubbard-Lehr-Willig argument here is incorrect, especially because they claim that price exceeds the efficient level.[36]

32. Professors Hubbard, Lehr, and Willig emphasize the ILEC's incumbency advantage and how that advantage manifests itself in terms of large cost differentials between ILECs and CLECs.[37] The sources of those supposed cost differentials, however, are nonexistent. For example, contrary to the suggestion of Professors Hubbard, Lehr, and Willig, ILECs must pay assemblage costs. Surely Professors Hubbard, Lehr, and Willig do not believe that ILECs can procure those activities for free. Indeed, their own example concerning system integration illustrates a cost faced by both CLECs and ILECs.[38] Again, Professors Hubbard, Lehr, and Willig are essentially asking the Commission to impose a mandatory unbundling standard that effects a subsidy for CLECs.

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34. Declaration of Janusz A. Ordover & Robert D. Willig, appended to AT&T's and TCI's Joint Reply to Comments and Joint Opposition to Petitions to Deny or to Impose Conditions 20 ¶ 49 (emphasis in original) (Nov. 13, 1998), in Joint Application of AT&T Corp. and Tele-Communications, Inc. for Transfer of Control to AT&T of Licenses and Authorizations Held by TCI and Its Affiliates or Subsidiaries, CS Dkt. No. 98-178. It is clear from an earlier passage in the affidavit that, by the phrase "rates that do not reflect proper economic costs," Professor Willig refers to TELRIC-based pricing of inputs. *Id.* at 16-17 ¶¶ 38-40.

35. *Hubbard-Lehr-Willig Affidavit* at 9 ¶ 20.

36. Average cost only influences the entry decision, and we have already seen much CLEC entry. Most entry is an inframarginal decision. It is not taking place at the margin.

37. *Hubbard-Lehr-Willig Affidavit* at 15 ¶¶ 28-29.

38. *Id.* at 10 ¶ 22.

33. Finally, Professors Hubbard, Lehr, and Willig attempt to reconcile their radical approach with the Supreme Court's directive that the Commission look outside the ILEC's network for alternative sources of supply of network elements: "If the CLEC is forced to purchase the network element from another source at a price that exceeds the incumbent LEC's cost (per unit) of self-providing that network elements (*i.e.*, TELRIC per unit), then the CLEC has higher costs than the LEC."[39] The Commission's adoption of such a standard would imply that, even if the CLEC could purchase the network element from another source at less than TELRIC-based rates (but not below the per-unit TELRIC), the CLEC would be sufficiently impaired to justify government intervention in the form of mandatory unbundling. This result will occur because a "reasonable allocation of forward-looking common costs" is included in TELRIC-based rates under the Commission's *Local Competition First Report and Order*.[40] More fundamentally, if the CLEC can purchase the network element from "another source" besides the ILEC, then that element cannot be an input that, if not supplied by the ILEC to the CLEC at a TELRIC price, could impair competition in the supply of telecommunications services to end users.

39. *Id.* at 11 ¶ 23.

40. Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers, First Report and Order, CC Dkt. Nos. 96-98, 95-185, 11 F.C.C. Rcd. 15,499, 15,874 ¶ 682 (1996).

V. PROFESSORS HUBBARD, LEHR, AND WILLIG CANNOT RECONCILE THEIR RECOMMENDATION OF UNIFORM NATIONWIDE UNBUNDLING OUTCOMES WITH CONSUMER WELFARE OR THE ACCEPTED TECHNIQUES OF COMPETITIVE ANALYSIS

34. Professors Hubbard, Lehr, and Willig advocate rules for mandatory unbundling that would have the effect of imposing uniform, nationwide *outcomes*. That recommendation is unsound as a matter of public policy for reasons that we explained in our earlier affidavit. It is also inconsistent with the reliance that Professors Hubbard, Lehr, and Willig place on the concept of a "local telecommunications market" elsewhere in their own affidavit. We address first this logical inconsistency in the Hubbard-Lehr-Willig affidavit.

35. Professors Hubbard, Lehr, and Willig say that the imposition of a meaningful limiting principle on mandatory unbundling would "reduce the viability or scope of a CLEC's service offerings" in a "competitive *local* telecommunication market."[41] Later in their affidavit, they again say that the competitive effects of the presence or absence of a policy on mandatory unbundling at TELRIC prices will manifest themselves at the local level: "In addition, impairment could reveal itself as a delay in entry to *a particular geographic, customer, or product market*."[42] This assessment by Professors Hubbard, Lehr, and Willig of the importance of evaluating competition at the local level supports our own conclusion that the Commission should make specific factual determinations about mandatory unbundling at the level of the relevant geographic market, as that concept is understood in antitrust law and

41. *Hubbard-Lehr-Willig Affidavit* at 7 ¶ 16 (emphasis added).
42. *Id.* at 13 ¶ 26 (emphasis added).

competitive analysis in regulatory proceedings. It is logically inconsistent, and thus not a sound basis for making policy, to say (as Professors Hubbard, Lehr, and Willig advocate) that uniform national outcomes for mandatory unbundling should be imposed to prevent competitive impairment that would reveal itself in the facts and circumstances of a particular geographic market.

36. Quite apart from producing this logical inconsistency in their argument, Professors Hubbard, Lehr, and Willig cannot find support in economic reasoning for their recommendation that the Commission impose uniform, national unbundling outcomes by Beltway edict. To the contrary, economic reasoning indicates that consumer welfare would suffer as a result of such an interpretation of section 251(d)(2). To the extent that they are present in the ILEC's provision of local telephony, economies of scale and scope are likely to arise overwhelmingly on a local—not national—basis. Despite this location-dependent nature of economies of scale and scope in local telephony, Professors Hubbard, Lehr, and Willig do not ask what will be the effect that mandatory unbundling at TELRIC prices will have *on competition*, because that question presents for them an inconvenient answer: As documented in the initial comments of the ILECs and the United States Telephone Association, competition (both in the supply of network elements and in the supply of telecommunications services to end users) is already extant in certain geographic markets and varies considerably in degree from one geographic market to the next. Instead, Professors Hubbard, Lehr, and Willig ask only what will be the effect that mandatory unbundling at TELRIC prices will have *on CLECs*.

37. In our earlier affidavit, we provided several explanations for why the Commission should apply its rules on mandatory unbundling locally, at the level of the relevant

geographic market.[43] First, without geographic specificity to its mandatory unbundling rules, the Commission would create a body of law in direct conflict with the antitrust principles that the Supreme Court considered relevant to interpreting section 251(d)(2). The references by Justices Scalia and Breyer to the essential facilities doctrine reinforce that the Commission must evaluate competition with respect to a meaningful geographic market.[44] Otherwise, the agency will fail to supply the limiting principle for mandatory unbundling that the Court ordered it to supply.

38. Second, the costs of local exchange telephony (particularly the cost of loops, given differences in loop lengths) vary greatly across different geographic areas of the country. The Commission should expect those differences in costs to lead to differences in competition and, hence, differences in the degree to which the imposition of mandatory unbundling at TELRIC prices could be justified.

39. Third, if the Commission followed the advice of Professors Hubbard, Lehr, and Willig and imposed a nationwide standard that ensured uniform nationwide outcomes, the agency would directly contradict the market definition standards found in the Department of Justice and Federal Trade Commission *Merger Guidelines,*[45] which the FCC has used in its own recent merger reviews under the public interest standard of the Communications Act.[46]

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43. *Hausman-Sidak Affidavit* at 78-83 ¶¶ 105-12.

44. *Iowa Utilities Board*, 119 S. Ct. at 734-35 (Scalia, J.); *id.* at 753 (Breyer, J.).

45. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines § 1.2 (1992).

46. *See, e.g.,* Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., Memorandum Opinion and Order, CC Dkt. No. 97-211, 13 F.C.C. Rcd. 18,025, 18,048-50 ¶¶ 37-39 (1998) (citing *Merger Guidelines*).

40. Fourth, many of the critical facts needed to assess competitive conditions are likely to be unique to a particular geographic market. The state public utility commissions have valuable expertise and resources with which to assist the FCC as local finders of fact.

41. To summarize, in a given geographic market, the correct question for the Commission to ask is whether an (unregulated) ILEC could exercise market power in the supply of telecommunications services to consumers if it were not required to provide CLECs a particular unbundled element at regulated cost-based rates. It is likely that the outcome of that competitive analysis will differ depending on the particular element and the geographic area under consideration.

CONCLUSION

42. For five reasons, the Commission should reject the policy preferences advocated in the Hubbard-Lehr-Willig affidavit. First, Professors Hubbard, Lehr, and Willig never define impairment in terms of consumer welfare. They explore impairment only in the context of a particular "CLEC's ability to offer service."[47]

43. Second, their analysis is based on a faulty understanding of CLEC investment and entry decisions. Contrary to the arguments of Professors Hubbard, Lehr, and Willig, mandatory unbundling at TELRIC prices not only will fail to stimulate CLEC investment, but also will *undermine* a CLEC's investment incentives. The decline in CLEC investment will

47. *Hubbard-Lehr-Willig Affidavit* at 21 ¶ 42.

result in fewer choices for consumers and thus will decrease consumer welfare.

44. Third, mandatory unbundling at TELRIC prices is not necessary to protect consumers in related telecommunications markets. Professors Hubbard, Lehr, and Willig are trapped in a narrow, competitor-welfare framework. That framework blinds them to any consideration of telecommunications competitors outside the conventional model of ILECs and CLECs.

45. Fourth, the Hubbard-Lehr-Willig impairment standard is ill-conceived and unworkable. The CLEC's entry decision is much more complicated than the simple assessment of cost differentials upon which Professors Hubbard, Lehr, and Willig would have the Commission rely.

46. Fifth, the national unbundling prescription of Professors Hubbard, Lehr, and Willig cannot be reconciled with consumer welfare and the accepted economic techniques of competitive analysis. Professors Hubbard, Lehr, and Willig ignore the costs to consumer welfare that would result if the Commission were to accept their advice of needlessly imposing nationwide unbundling outcomes that ignore the competitive differences that exist across relevant geographic markets.

47. Under the impairment standard proposed by Professors Hubbard, Lehr, and Willig, mandatory unbundling at TELRIC prices would be triggered "whenever the evidence *reasonably* suggests that a CLEC's ability competitively to offer local service or exchange

access service would be impaired."[48] The standard analysis of competition contained in antitrust law and regulatory economics counsels the Commission to reject the Hubbard-Lehr-Willig impairment standard on the grounds that it lacks the kind of meaningful limiting principle that prompted the Supreme Court in *Iowa Utilities Board* to remand this proceeding to the Commission.

48. *Id.* at 21¶ 43 (emphasis added).

I hereby swear, under penalty of perjury, that the foregoing is true and correct.

J. Gregory Sidak

J. Gregory Sidak

Executed on this 10th day of June, 1999.

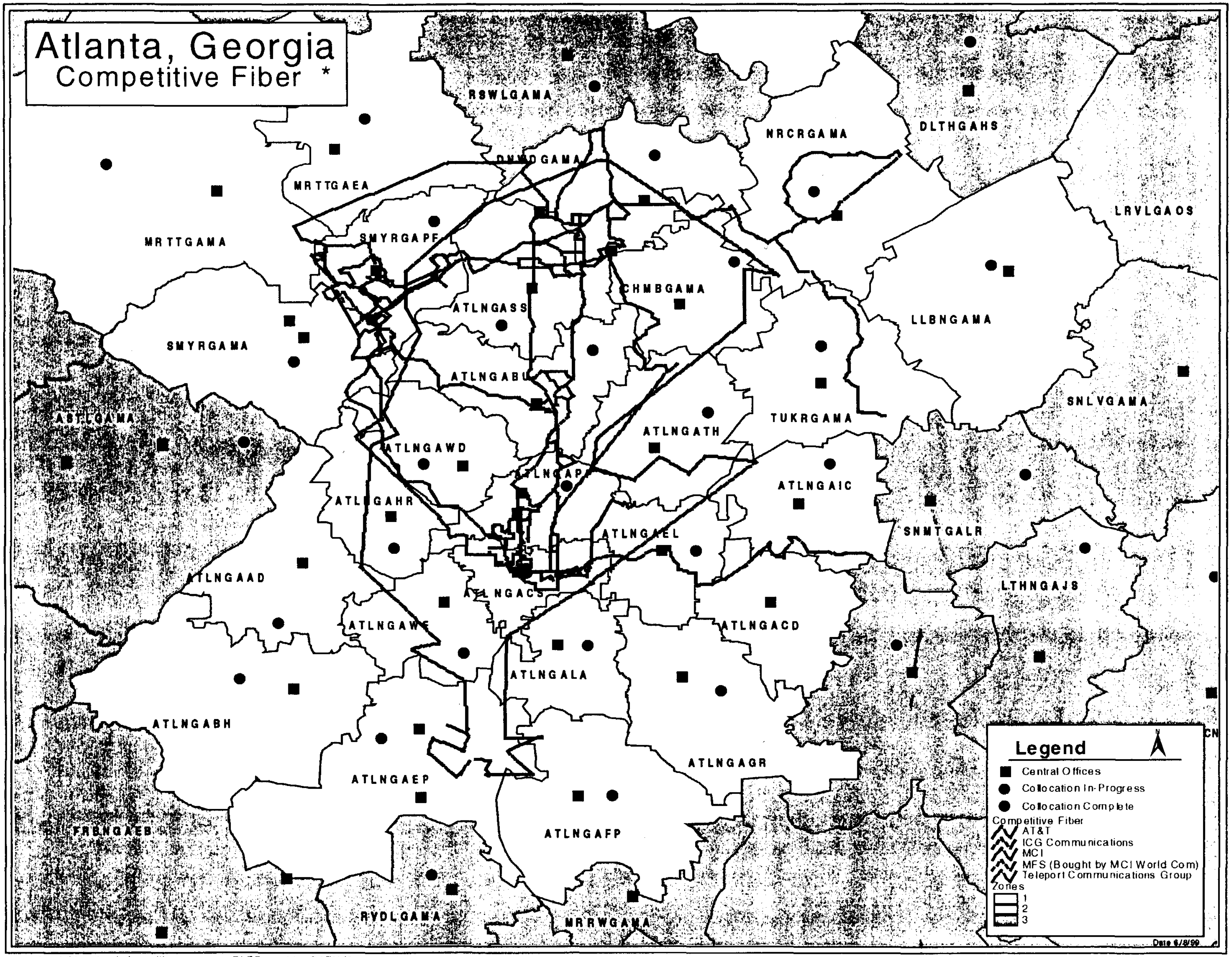
Charlotte S. Brown

Notary Public

4/30/03

My commission expires:

Attachment C



* Additional existing utility company, CLEC, and/or CATV fiber not shown